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UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF CALIFORNIA

In re

IMDAD and SITARA KHAN,
Debtors.

Case No. 91-56128-MM

Chapter 11

**MEMORANDUM DECISION AND
ORDER SUSTAINING OBJECTION
TO CLAIM OF DELTA COSTANZO**

INTRODUCTION

The confirmed chapter 11 plan of Imdad and Sitara Khan provides for payment in full to their unsecured creditors. The Khans, however, object to the claim filed by Delta Costanzo. Costanzo's claim seeks recovery on eleven promissory notes now totaling \$740,735, which were, before foreclosure of a senior obligation, secured by the Khans' real property. Because the Khans are entitled to the protection of California Civil Procedure Code § 580b, the objection is sustained, and Costanzo's claim is disallowed.

FACTUAL BACKGROUND

The property involved in this action is an eleven-building fourplex complex located on Alvarado-Niles Road in Union City, California (the "Alvarado-Niles Property" or the "Property"). Costanzo sold the Property in 1978, subject to an existing deed of trust in favor of Fidelity Savings, to Edwin P. Carter, and took back a \$900,000 promissory note, secured by a wrap-around deed of trust (the "Carter Note"). Carter later deeded a 2/7th share of the Property to Stephen Miller (together, "Carter/Miller").

1 In 1981, Carter/Miller sold the Property, in violation of the due-on-sale clause in Costanzo's
2 deed of trust, to the Alvarado-Niles Four-Plex Group, a limited partnership. The partnership paid
3 \$2,017,177, with \$179,677 in cash and a promissory note for \$1,847,500, secured by an all-inclusive
4 deed of trust which wrapped around Fidelity's first deed of trust and Costanzo's wrap-around second
5 deed of trust.

6 When this partnership filed for bankruptcy, the debtor-in-possession sold the Property to
7 Thomas Tomanek for \$2,250,000. Tomanek obtained a senior loan from World Savings of
8 \$2,019,600 and gave eleven purchase-money notes with a total obligation of \$400,000 to Costanzo
9 (the "Tomanek Notes"), secured by new junior deeds of trust in full satisfaction of the Carter Note.
10 In 1983, Tomanek sold the property to the Khans, who assumed the existing first deed of trust, issued
11 replacement notes to Costanzo (the "Khan Notes") and paid \$286,160 in cash. The Khans eventually
12 defaulted, and World Savings foreclosed on the Property, leaving Costanzo as a sold-out junior on
13 the Khan Notes.

14 Costanzo then brought suit in Superior Court for the County of Alameda to recover on the
15 Khan Notes. That court granted summary judgment to Costanzo, awarding the balance due. On
16 appeal, the First District Court of Appeals reversed and directed that judgment be entered for the
17 Khans. However, because the Khans had not filed their own motion for summary judgment, on
18 reconsideration, the Court of Appeals withdrew that portion of the opinion that ordered that
19 judgment be entered for the Khans. The California Supreme Court declined to review the case.

20 After the Khans filed their chapter 11 case, the litigation continued in this court. On the
21 parties' cross motions for summary judgment, the Khans asserted that the opinion of the First District
22 Court of Appeals was the law of the case and consequently did not controvert the additional evidence
23 that Costanzo submitted. The court granted the Khans' motion for summary judgment and denied
24 Costanzo's motion for summary judgment. On appeal, the District Court reversed and remanded.

25 The District Court concluded that the decision of the First District Court of Appeals was not
26 the law of the case since new facts were presented in the record before the bankruptcy court. The
27 District Court ordered this court to conduct further proceedings to consider the following four factual
28 issues, which are directed to determining whether the anti-deficiency statute applies and whether the

purposes of § 580b are served:

1. Did Carter/Miller actively participate in the Four-Plex sale?
2. Was Carter/Miller necessary to the Four-Plex sale?
3. (a) Did Carter/Miller unreasonably overvalue the property in the Four-Plex sale?
(b) If so, should Carter/Miller have known that the property was overvalued?
4. (a) Did Costanzo have an opportunity to have her initial note retired so that she would no longer be subject to the section 580b anti-deficiency rules?
(b) If so, did Costanzo elect to take an assignment of the Tomanek Notes for tax reasons?

In re Imdad and Sitara Khan, No. 94-4339 FMS (N.D. Cal. filed Mar. 27, 1995).

Rather than renewing their motions for summary judgment before this court, the parties proceeded to trial on the merits. The court's Pre-Trial Order, filed November 21, 1995, sets forth those facts that are stipulated by the parties. The facts are also contained in the published opinion of the First District Court of Appeals in Costanzo v. Ganguly, 12 Cal. App.4th 1085, 16 Cal. Rptr.2d 55 (Cal. App. (1st Dist.) 1993). It was further stipulated during trial that the total principal and accrued interest due under the Khan Notes is \$740,735.40 accruing at the rate of \$116.12 per diem from December 1, 1995 until entry of judgment. This Memorandum Decision addresses the 26 remaining disputed issues of fact and the 17 issues of law identified by the parties in the court's Pre-Trial Order.¹ The court's findings with respect to the issues of fact identified by the parties are set forth below chronologically by transaction.

FINDINGS OF FACT

I. Costanzo's Sale to Carter/Miller in 1978

Issue 8. To what degree was Mrs. Costanzo knowledgeable and sophisticated about real estate secured transaction procedure and law?

¹ Counsel raise as a legal issue whether Costanzo should be reimbursed for payments made to the receiver prior to foreclosure of the Property. This issue was not briefed or argued; however, the court is not aware of any legal basis that reimbursement by the Khans would be required.

1 Issue 9. Did Mrs. Costanzo use or have access to professional advisors including, but not
2 limited to accountants and lawyers?

3 Issue 10. What were the circumstances and motivations surrounding Mrs. Costanzo's sale
4 of the Alvarado-Niles Property in 1978?

5 Issue 11. What were the terms and conditions of the sale of the Alvarado-Niles Property to
6 Carter in 1978?

7 Issue 12. Did Carter have a history of failing to make payments or of making late payments
8 on the note owed to Mrs. Costanzo?

9 Issue 13. Prior to electing to take an assignment of the Tomanek promissory notes, did Mrs.
10 Costanzo ever pursue, or have the opportunity to pursue, any remedies against Carter as a result of
11 his failure to make payments on the note owed to her?

12
13 The Alvarado-Niles Property was acquired by Delta and Louie Costanzo during their
14 marriage, was developed by Louie Costanzo, and was awarded to Delta Costanzo upon dissolution
15 of the marriage in 1976. Until 1976, Costanzo was not employed outside of the home. During her
16 twenty-nine year marriage, her husband made all the investment and business decisions without
17 consulting her, and she relied upon him to read and tell her whether to sign legal and financial
18 documents. After the divorce, Costanzo moved into one of the fourplex units and managed the
19 property, with the assistance of her daughter, until she sold it in 1978. With limited practical business
20 experience and only a high school education, Costanzo was not then personally knowledgeable or
21 sophisticated regarding real estate transactions. However, since her marriage dissolved, Costanzo
22 has held investment interests in real estate, real estate limited partnerships, oil and gas limited
23 partnerships, securities, bonds, and tax-deferred annuities. She owned an ice cream store and
24 restaurant, and has operated a Christian bookstore and a Christian referral service. She also
25 maintained an investment account at Shearson, Lehman.

26 Although Costanzo may not have been personally sophisticated or knowledgeable, she
27 employed and relied upon accountants, lawyers, at least one stockbroker, and other professionals who
28 were knowledgeable and sophisticated regarding secured investments in real property, including

1 relevant procedures and law, as well as other investments. Costanzo hired James M. Shank, C.P.A.,
2 within a year of her divorce in 1976 to handle all of her financial affairs. Subsequently, she retained
3 Robert E. Hawn, C.P.A., when Hawn acquired Shank's practice in 1981. Costanzo also retained
4 Steven Bernard, Esq. to represent her in the divorce. With Hawn's assistance, Costanzo retained
5 Patricio Letelier, Esq. in 1981 and Philip Rivera, Esq. in 1982. It was customary for Costanzo to
6 forward legal and financial documents to her advisors for review and recommendation. Costanzo
7 testified that she frequently signed documents without reading them, because she generally could not
8 understand business documents, and that she would not ask for clarification if she believed that she
9 wouldn't understand the explanation.

10 Robert Hawn, her accountant from 1981 until 1988, testified that she was not naive and that
11 she developed a basic knowledge of business over time. Hawn testified that Costanzo understood
12 the significance of a first deed of trust, an all-inclusive deed of trust, foreclosure, and "carry-back"
13 notes. Costanzo denies understanding the meaning of a deed of trust as of 1984; however, her
14 testimony is self-serving. It is clear to the court that Costanzo is an intelligent woman who has
15 learned how to protect her interests.

16 When Costanzo sold the Alvarado-Niles Property to Carter in 1978, the sales price was
17 \$1,250,000, of which \$900,000 was financed by a promissory note, payable over ten years at the
18 annual rate of 8.25%, secured by an all-inclusive deed of trust in favor of Costanzo. This deed of
19 trust wrapped around a first deed of trust in favor of Fidelity Savings with a balance remaining of
20 \$408,400.10. The Carter Note contained a due-on-sale clause. Carter made a cash down payment
21 of \$350,000. He later conveyed a 2/7ths fractional interest to Stephen Miller by grant deed recorded
22 in March 1979. Carter's payment history to Costanzo on the note was sporadic. Payments were
23 frequently late or made with "insufficient funds" checks and occasionally missed altogether. Costanzo
24 retained at separate times lawyers Patricio Letelier and Philip Rivera to collect on the Carter Note
25 and to record a notice of default. Costanzo's actions make clear her awareness that if Carter
26 defaulted on the note, she could foreclose her interest in the Property pursuant to her second deed
27 of trust.

II. Carter's Sale to the Four-Plex Group in 1981

Issue 14. When did Mrs. Costanzo and/or her agents have knowledge of Carter's sale of the Alvarado-Niles Property to the Four-Plex Group?

Issue 15. What were the terms and conditions of the sale of the Alvarado-Niles Property from Carter to the Four-Plex Group in 1981?

Issue 16. What was Carter's involvement in the Four-Plex Group's bankruptcy proceeding?

Without honoring the due-on-sale provisions in the Carter Note or advising Costanzo, Carter/Miller sold the Property to the Alvarado-Niles Four-Plex Group, a limited partnership, in May 1981. The Four-Plex Group was organized by general partners Don and Carmen Goodman, who were realtors operating under Carter's real estate brokerage. The purchase price was \$2,017,177, consisting of a cash payment of \$169,677 and a wrap-around promissory note for \$1,847,500. The note to Carter/Miller was payable over ten years at the annual rate of 12.75% and secured by an all-inclusive deed of trust in favor of Carter/Miller, which wrapped around Fidelity Savings' first deed of trust and Costanzo's wrap-around second deed of trust. Costanzo first learned of Carter/Miller's sale of the Alvarado-Niles Property to the Four-Plex Group in February 1983 when Carter, in response to a collection letter from Philip Rivera, Costanzo's attorney, wrote Rivera that the Property had been sold to a partnership that subsequently filed bankruptcy.

In hindsight, it appears that Carter/Miller unreasonably overvalued the Property and that Carter/Miller should have known that the Property was overvalued because of their own difficulty in servicing the debt to Costanzo. The net income from the Property was clearly insufficient to service the debt, and the Four-Plex Group promptly went into default on its note to Carter/Miller. Carter/Miller recorded a notice of default in October 1981 and published a notice of trustee's sale set for April 15, 1982. The Four-Plex Group sought bankruptcy protection on April 12, 1982.

Carter/Miller appeared before the bankruptcy court five times, vigorously prosecuting multiple motions for relief from the automatic stay. Following at least two hearings, the court continued the automatic stay for a minimum of 90 days and subsequently granted a "drop dead" date. However, when the court extended the "drop dead" date, Carter became convinced that he may never

1 be able to foreclose on the Property. Progress was not forthcoming on refinancing or selling the
2 Property, and Carter/Miller's position deteriorated while the case languished for seventeen months.

4 III. The Four-Plex Group's Sale to Tomanek in 1983

5 a. Pre-Sale Negotiations

6 Issue 1. Whether Carter "actively participated in" the sale of the Alvarado-Niles property
7 from the Four-Plex Group to Tomanek?

8 Issue 2. Whether Carter was "necessary to" the sale of the Alvarado-Niles Property from the
9 Four-Plex Group to Tomanek?

10 Issue 17. What were the negotiations between Tomanek and representatives of the Four-Plex
11 Group regarding Tomanek's purchase of the Alvarado-Niles Property?

12 Issue 18. What involvement did Mrs. Costanzo and/or her agents have in the Four-Plex
13 Group's bankruptcy?

14 Issue 25. Did Mrs. Costanzo and/or her agents know, or should she and/or her agents have
15 known, that the Alvarado-Niles Property was overvalued when it was sold to Tomanek in 1983?

16 Issue 26. Who benefitted from the sale of the Alvarado-Niles Property to Tomanek?

17
18 Carter denies having actively participated in the negotiations or having participated in
19 structuring the secondary financing for the sale to Tomanek. However, the court discounts this
20 testimony as not consistent with other evidence and instead finds that Carter "actively participated
21 in" the sale of the Alvarado-Niles Property from the Four-Plex Group to Tomanek.

22 Tomanek originally offered to purchase the Property for \$2,068,000 in negotiations with the
23 Goodmans, the Four-Plex Group general partners. However, as it was obvious that the Four-Plex
24 Group would receive nothing from the sale, the Goodmans' continuing participation in the
25 negotiations was minimal. Tomanek testified that the Goodmans countered Tomanek's offer because
26 Carter demanded a higher price and that it was Carter who dictated the terms of sale. The only
27 significant decision left to the Goodmans was to select the title company.

1 Carter personally attended each of the hearings before the bankruptcy court. Heinz Binder,
2 bankruptcy counsel for the Four-Plex Group, was attempting to negotiate a reduction in
3 Carter/Miller's secured claim in order to generate sufficient proceeds from the sale to fund a chapter
4 11 plan. Binder recounted a lengthy, perhaps day-long, meeting to discuss an accounting of the
5 secured debt to Carter/Miller with Carter, whom he described as "vocal."

6 The Four-Plex Group ultimately sold the Property to Tomanek for \$2,250,000. The increase
7 in price from Tomanek's offer benefitted only Carter/Miller, who held the most junior deed of trust,
8 but Carter/Miller was still required to reduce its demand by \$37,500 in order to close escrow. The
9 bankruptcy estate retained \$100,000 from the total purchase price, which was just sufficient, when
10 combined with other estate assets, to cover rent deposits, closing costs, and costs of administration
11 and to fund a plan paying a distribution of approximately 30% to unsecured creditors of the estate.

12 Carter also negotiated the terms of the secondary financing, because he originally intended
13 to accept a promissory note secured by a second deed of trust. As further evidence of the extent to
14 which Carter was involved in the negotiations, Carter was so impressed with the terms of the loan
15 that Tomanek obtained from World Savings that he requested an introduction to Tomanek's loan
16 officer. In fact, the bankruptcy court order approving the terms of the sale and the compromise to
17 reduce the amount of Carter/Miller's secured claim, which Binder drafted, includes a provision at
18 Carter's request requiring Tomanek to introduce Carter to Tomanek's loan officer.

19 Carter's participation was also necessary to the sale of the Alvarado-Niles Property. Counsel
20 for the Four-Plex Group did not request a sale of the Property "free and clear of liens," but simply
21 an order approving the sale. The ramifications of a simple order approving a sale on oversecured
22 property are that the demands in escrow of secured creditors must be consensually reduced for
23 escrow to close on the terms proposed. Without Carter's consent to the terms of the sale, the escrow
24 would not have closed.

25 Accompanied by her accountant, Costanzo attended the hearing in August 1983 approving
26 the terms of the sale to Tomanek. However, Costanzo's involvement in the bankruptcy case was
27 otherwise minimal, and neither she nor her accountant participated in the negotiations with Tomanek
28

1 on the primary or the secondary financing, as all parties assumed at the time that Costanzo would
2 require payment in full from the escrow.

3 Carter/Miller ultimately benefitted from the sale of the Alvarado-Niles Property from the
4 Four-Plex Group to Tomanek in September 1983. Although Carter/Miller voluntarily reduced their
5 demand in escrow, Carter/Miller received approximately \$750,000 from the close of escrow upon
6 assignment of the Tomanek Notes to Costanzo.

7
8 b. Overvaluation

9 Issue 3. Whether the seller of the Alvarado-Niles Property overvalued the Property when it
10 was sold by the Four-Plex Group to Tomanek in 1983?

11 Issue 21. Did Tomanek overvalue the Alvarado-Niles Property when he purchased the
12 Property in 1983?

13 Issue 22. Did World Savings overvalue the Alvarado-Niles Property when it appraised the
14 Property in 1983 in conjunction with Tomanek's application for a loan to purchase the Property?

15 Issue 23. Did Carter overvalue the Alvarado-Niles Property when it was sold to Tomanek
16 in 1983?

17 Issue 24. Should Carter have known the Alvarado-Niles Property was overvalued when it
18 was sold to Tomanek in 1983?

19
20 The \$2,250,000 price obtained by the Four-Plex Group, as seller of the Alvarado-Niles
21 Property to Tomanek, represented the fair market value inasmuch as it was determined after arms'-
22 length negotiations between a willing buyer and a willing seller. However, for § 580b purposes, the
23 Property was overvalued because neither its income nor its expected future appreciation would
24 support the price paid. Moreover, the Four-Plex Group should have known that the rental proceeds
25 from the Property were insufficient to service the loan, based on its own inability to service the
26 Carter/Miller financing.

27 In connection with Tomanek's loan application, World Savings had the Property appraised
28 in June 1983 at \$230,000, per unit, or \$2,530,000, which was excessive. Through an oversight by

1 World Savings, the escrow closed with financing on the Property in excess of Tomanek's purchase
2 price and in excess of the loan-to-value ratio mandated by federal regulation. On the total purchase
3 price of \$2,250,000, the loan from World Savings in first position was \$2,019,600 and the eleven
4 secured promissory notes in second position totaled \$400,000. Although Tomenek did not
5 necessarily overvalue the Property, the closing statement for the escrow reflects that Tomanek
6 received \$116,536.83 out of escrow. Tomanek testified that a portion of those funds were
7 attributable to security deposits, operating cash, unpaid taxes, and rent proration and did not
8 constitute cash in hand on close of escrow. He further explained that, in his view, this was justified
9 because he reinvested this money, as well as additional funds, in the Property. Costanzo received
10 approximately \$117,000 from escrow and the eleven promissory notes assigned from Carter/Miller.

11 Carter should have known that the Alvarado-Niles Property was overvalued when the
12 Property was sold to Tomanek in 1983. During the pendency of the bankruptcy case, there were
13 valuation hearings on Carter/Miller's motions for relief from the automatic stay wherein Carter/Miller
14 requested permission to foreclose on the Property. Certainly, Carter, as a real estate professional,
15 was aware that the liens on the Property exceeded Tomanek's purchase price, which explains why
16 he requested introduction to Tomanek's loan officer. However, Carter also testified that he did not
17 have a duty to advise Costanzo, and, in fact, he did not advise her that the Property was
18 overencumbered when he assigned the Tomanek Notes to her.

19
20 c. Post Sale Negotiations

21 Issue 19. Did Mrs. Costanzo, at the time of the sale of the Alvarado-Niles Property from the
22 Four-Plex Group to Tomanek in 1983, have the opportunity to have the Carter note to her paid off?

23 Issue 20. Did Mrs. Costanzo elect to take an assignment of the Tomanek notes for tax
24 reasons?

25
26 At the time of the sale of the Alvarado-Niles Property from the Four-Plex Group to Tomanek
27 in 1983, Costanzo had the opportunity to retire the Carter Note. The transaction, as originally
28 structured, contemplated that Costanzo would be paid and that Carter/Miller would receive the eleven

1 notes totaling approximately \$400,000. Instead, Hawn approached Carter on Costanzo's behalf,
2 seeking to assign the Tomanek Notes to her. Hawn testified that cash payment to Costanzo would
3 have generated a substantial capital gains tax liability. Upon learning of the adverse tax
4 consequences, Costanzo decided to accept an assignment of the Tomanek Notes rather than payment
5 of the Carter Note. Hawn testified that Costanzo never protested his advice, his accepting the
6 assignment as her agent, or the receipt of payments directly from Tomanek before 1988. A
7 worksheet prepared by Hawn and introduced into evidence reflects that Costanzo's exposure to tax
8 liability had she been paid in cash from the close of escrow would have been \$226,054, while her tax
9 liability resulting from collections on the notes was projected at \$113,023. Hawn's testimony is
10 credible.

11 Costanzo's testimony contradicts Hawn's in that she denied that Hawn advised her of the
12 adverse tax consequences of accepting payment in full and denied that she authorized Hawn to accept
13 an assignment of the eleven Tomanek Notes and deeds of trust on her behalf. This conflict between
14 the testimony of Hawn and Costanzo was the basis of Costanzo's lawsuit against Hawn in 1988. In
15 that suit, Costanzo asserted a claim for professional negligence, contending that Hawn accepted the
16 assignment of the Tomanek Notes and trust deeds without her consent or authority. These claims
17 against Hawn were settled for \$40,000, and the settlement was approved as a good faith settlement
18 under California law.

19 Again, it appears to the court that Costanzo's testimony is self-serving and her memory
20 selective. The court finds that Costanzo elected to accept the Tomanek Notes in order to avoid the
21 adverse tax consequences of payment in full on the Carter Note. It is not relevant to these
22 proceedings whether Hawn was acting within the scope of his authority or whether Costanzo was
23 aware of the actions of her agent.

24 25 IV. Tomanek's Sale to the Khans in 1984

26 Issue 27. What were the terms and conditions of the sale of the Alvarado-Niles Property to
27 the Khans in 1984?
28

1 Issue 4. Whether the seller of the Alvarado-Niles Property overvalued the Property when it
2 was sold by Tomanek to the Khans and Gangulys in 1984?

3 Issue 28. Did Mrs. Costanzo at the time of the sale of the Alvarado-Niles Property to the
4 Khans in 1984, have the opportunity to have the assigned notes from Tomanek paid off?

5
6 The purchase price of the sale of the Alvarado-Niles Property when sold to the Khans in 1984
7 was \$2,861,600. The terms of sale provided for assumption of the existing financing and the payment
8 of \$286,160 in cash. For some reason not clear from the record, the Khans executed eleven new
9 notes to Costanzo rather than assuming the Tomanek Notes. The Khans purchased this Property in
10 partnership with the Gangulys; however, the Gangulys' participation is not relevant for purposes of
11 this proceeding.

12 Tomanek overvalued the Alvarado-Niles Property when he sold it to the Khans. At the time
13 of the sale to the Khans, nine months after Tomanek's escrow closed, the Property was encumbered
14 by a first deed of trust securing a loan for \$2,019,600 from World Savings and second deeds of trust
15 in favor of Costanzo securing the eleven notes which had been assigned to Costanzo totaling
16 approximately \$400,000. World Savings had appraised the Property in June 1983 at \$230,000 per
17 unit, or \$2,530,000. Tomanek testified that he had offered the Property at \$2,800,000 and that the
18 price was based on the gross income multiplied by ten. The Khans agreed to pay \$2,681,000. The
19 original terms provided for assumption of the World Savings loan and \$639,000 in cash plus trades.
20 By then, the principal owing on the World Savings loan had increased to \$2,042,000 because it was
21 a negative amortization loan. After failing to find a suitable property for trade purposes, the Khans
22 assumed the World Savings loan and executed eleven new notes and deeds of trust in favor of
23 Costanzo for \$384,155.42, representing the unpaid principal balance of the Tomanek Notes.

24 At the time of the sale of the Alvarado-Niles Property from Tomanek to the Khans in 1984,
25 Costanzo again had the opportunity to have the Tomanek Notes assigned to her retired. At trial,
26 Costanzo testified that she called Hawn from the title company in tears when she discovered she
27 would not be paid in cash and, further, that she was unaware she could have demanded full payment
28 of the Tomanek Notes. She also testified that she had a conversation with her former husband, Louie

1 Costanzo, who told her there was a problem concerning the Property, but she did not recall when the
2 conversation occurred. However, her deposition testimony taken in 1988 was read into the record.
3 At that time, it was her testimony that Louie Costanzo advised her before she accepted the Khan
4 Notes that the Property was overencumbered because there were too many loans against the
5 Property following the sale to Tomanek. In sur-rebuttal, Louie Costanzo testified that this
6 conversation never occurred. The court finds that Costanzo's testimony at trial was impeached by
7 her deposition testimony in 1988 and that neither the testimony of Delta Costanzo nor the testimony
8 of Louie Costanzo on this point is credible. Although Costanzo had another opportunity to have the
9 Khan Notes to her retired, either Costanzo or her agent, Hawn, again declined cash payment because
10 of the adverse tax consequences arising from capital gains taxes. Costanzo and her agents knew or
11 should have known that the Property was overvalued when it was sold to the Khans.

12 13 V. Factors Affecting Valuation

14 Issue 5. Whether there was a general depression in land values at or after the Khans
15 purchased the Alvarado-Niles Property?

16
17 There was a dispute as to the admissibility of the testimony of Costanzo's expert, Wayne Rice,
18 at trial. The court has considered the expert testimony and finds that no persuasive evidence was
19 presented to the court; however, the court takes judicial notice of a general depression in land values
20 at or after the time the Khans purchased the Alvarado-Niles Property in 1984. Moreover, the court
21 notes that during the sixteen years since Costanzo's ownership, the Property suffered from inattention
22 to maintenance. Photographs of the Property introduced into evidence portray a slum-like
23 environment, with broken and boarded windows, abandoned and burnt vehicles, and neglected foliage
24 and landscaping. The Property also may have become less desirable as a result of changes in the tax
25 laws in 1986.

26 **POSITIONS OF THE PARTIES**

27 Counsel for Costanzo prepared a diagram outlining his analysis of the law under § 580b.
28 Pivotal to this analysis is his interpretation of the California Supreme Court's decision in Kistler v.

1 Vasi, 78 Cal. Rptr. 170, 455 P.2d 106 (1969), and his assessment that Kistler is not distinguishable
2 from the case at bar. Applying Kistler, counsel asserts that Costanzo's position in the sale to the
3 Khans should be characterized as that of a third-party lender and that, consequently, she is entitled
4 to a deficiency judgment.

5 Alternatively, counsel argues that Costanzo is entitled to a deficiency judgment because Carter
6 was not an active participant in the sale of the Property to Tomanek in 1983, arguing that Tomanek
7 controlled the terms of the transaction. He further argues that Carter was not necessary to the
8 transaction because Tomanek could have closed the sale without any accommodation from
9 Carter/Miller.

10 Finally, Costanzo's counsel contends that Costanzo did not knowingly authorize the
11 assignment of the Tomanek Notes from Carter/Miller and that the policy and purposes of § 580b
12 would not be served because the Khans have not established that the Property was overvalued.

13 In response, counsel for the Khans submit three alternative arguments in support of their
14 position, any of which, they argue, would preclude Costanzo from receiving a deficiency judgment
15 under § 580b. First, they assert that, as the assignee of purchase-money notes, Costanzo is subject
16 to the § 580b defense, under the authority of LaForgia v. Kolsky, 196 Cal. App. 3d 1103, 242 Cal.
17 Rptr. 282 (Cal. App. (4th Dist.) 1987). Applying LaForgia, Carter/Miller was transformed into a
18 "vendor" in the sale to Tomanek because of Carter's active participation in negotiating the sale and
19 because Carter agreed to reduce the Carter/Miller secured debt in order to consummate the sale to
20 Tomanek.

21 Alternatively, the Khans' counsel urge that the notes from the Four-Plex Group to
22 Carter/Miller were purchase-money notes that retained their character notwithstanding that the notes
23 were rewritten during subsequent sales for new principal amounts. Ziegler v. Barnes, 200 Cal. App.
24 3d 224, 231 fn. 6, 246 Cal. Rptr. 69 (Cal. Ct. App. 1988).

25 Lastly, counsel argues that the Khan Notes represent the original purchase-money obligation
26 that arose when Costanzo sold the Alvarado-Niles Property to Carter in 1981 and retains its
27 purchase-money character for this reason. Brown v. Jensen, 41 Cal. 2d 193, 197, 259 P.2d 425, 427
28 (1953), cert. denied, 347 U.S. 905 (1954).

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1 the result that a subsequent assignee of a purchase money note is subject to the § 580b protections.
2 Ziegler v. Barnes, 200 Cal. App. 3d at 231 fn. 6.

3 Section 580b is applied automatically to standard transactions to preclude a deficiency
4 judgment against the buyer without any consideration of the equities or the policy behind the statute.
5 In commercial transactions, the traditional standard purchase money transaction is one where the
6 buyer gives the seller a promissory note for the balance of the purchase price secured by a deed of
7 trust on the property sold. Roseleaf Corporation v. Chierighino, 378 P.2d 97, 27 Cal. Rptr. 873, 876
8 (1963). Section 580b may be applied to “non-standard” transactions only if the policy of the statute
9 would be served.

10 11 2. Characterization of the Alvarado-Niles Property Transactions Bars Deficiency Judgment

12 Section 580b precludes Costanzo from obtaining a deficiency judgment under both the
13 second and the third theories urged by the Khans’ counsel because the relevant transactions are
14 purchase money in character. The sale by Costanzo to Carter in 1978 is a standard purchase money
15 transaction. Costanzo financed a portion of the purchase price by accepting a \$900,000 note from
16 Carter secured by a wrap-around trust deed. As a standard purchase money transaction, the Carter
17 Note is automatically subject to the protections of § 580b, and Costanzo would not be entitled to
18 recover a deficiency judgment based on that note. See Roseleaf, 27 Cal. Rptr. at 876.

19 Carter's subsequent sale to the Four-Plex Group in 1981 is also a standard seller-financed
20 transaction in which Carter carried back a note for \$1,847,500. This note, which was also secured
21 by a wrap-around trust deed so that Carter remained liable for payments under the original terms of
22 the purchase money to Costanzo, is subject to § 580b protections. The Carter Note retains its
23 character as a purchase money note subject to § 580b protection. See Brown v. Jensen, 41 Cal.2d
24 at 197.

25 The 1983 sale from the Four-Plex Group to Tomanek is a variation from the standard
26 transaction since a third party who was not the owner of the Property at the time of the sale extended
27 financing. The anti-deficiency statute does not automatically apply to variations to standard
28 transactions. However, this does not preclude a finding that the loan may be transmuted into a

1 purchase money loan, as discussed *infra*. LaForgia v. Kolsky, 196 Cal. App. 3d 1103, 242 Cal. Rptr.
2 282 (Cal. App. 1988). The eleven Tomanek Notes served to replace the note from the Four-Plex
3 Group to Carter/Miller and are secured by the same collateral. As a result, the Tomanek Notes
4 assumed the purchase money characterization of the Four-Plex Group note to Carter/Miller although
5 the amount and the terms of the note changed. See Ziegler v. Barnes, 200 Cal. App. 3d at 231. That
6 the Tomanek Notes were issued to purchase the Property in a sale approved by the bankruptcy court
7 has no effect on the characterization of the notes for purposes of the application of § 580b.

8 The Tomanek Notes were assigned to Costanzo at close of escrow in lieu of payment on the
9 Carter Note. The Tomanek Notes served merely to substitute for the Carter Note, which was
10 originally a purchase money note. As a result, the Tomanek Notes assumed the character of
11 purchase money notes because they are secured by the same property although the amount and terms
12 of the notes changed. Id.

13 When the Khans purchased the Property in 1984, the transaction was also structured as a
14 variation from a standard seller-financed sale. The Khans assumed the first loan to World Savings
15 & Loan and intended to assume the Tomanek Notes. Instead, the Khans executed eleven new notes
16 to Costanzo in an amount reflecting the original Tomanek Notes less the payments made by
17 Tomanek. Because the new Khans Notes substituted for the Tomanek Notes, they assumed the
18 purchase money character of the original Tomanek Notes that they replaced. Id. Costanzo never
19 advanced additional funds to either Tomanek or to the Khans. At all times, the notes that Costanzo
20 carried represented her equity in the Property from the original sale to Carter in 1978. Because of
21 the purchase money character of the notes, § 580b precludes a deficiency judgment against the
22 Khans.

23
24 B. Non-Standard Transactions Are Subject to
25 § 580b Only if Policy Served

26 Variations on the standard transaction are subject to § 580b only if they come within the
27 purposes of the statute. Roseleaf, 27 Cal. Rptr. at 876. The court concludes that the 1978 and 1981
28 sales transactions are standard purchase money transactions for purposes of application of § 580b.

1 However, the sale from the Four-Plex Group to Tomanek in 1983 and the sale from Tomanek to the
2 Khans in 1984 were not standard, seller-financed purchase money transactions. Although the court
3 has concluded that § 580b precludes Costanzo from obtaining a deficiency judgment, to the extent
4 that any of the other subject transactions are a variation from the standard, the court makes the
5 following conclusions for purposes of making a complete record and because the parties have
6 presented the legal issues for determination. Thus, applying the first theory urged by the Khans'
7 counsel, the Khans also prevail.

8 9 1. Transformation of Third Party Lender Into Vendor

10 Transmutation of a non-standard, non-purchase money transaction into a purchase money
11 transaction would preclude a creditor who is otherwise a non-purchase money creditor from obtaining
12 a deficiency judgment. Courts have construed the term "vendor" liberally for purposes of the anti-
13 deficiency statute. Jackson v. Taylor, 272 Cal. App. 2d 1, 76 Cal. Rptr. 891 (Cal. App. 1969);
14 Shepherd v. Robinson, 128 Cal. App. 3d 615, 623, 180 Cal. Rptr. 342 (Cal. App. 1981); LaForgia
15 v. Kolsky, 196 Cal. App. 3d 1103, 242 Cal. Rptr. 282 (Cal. App. 1988). That is, a variation from
16 the standard purchase money transaction may be transmuted into a purchase money transaction under
17 certain circumstances when financing is extended for the purchase of property. LaForgia, 242 Cal.
18 Rptr. at 288. A lienholder who participates in a sales transaction and agrees to extend financing to
19 a new purchaser in an attempt to save his security interest may properly be construed as a vendor if
20 necessary to effectuate the purposes of the anti-deficiency statute. Id. A third party lender may be
21 transmuted into a vendor of that party's interest as a beneficiary under the original trust deed if the
22 party was necessary to the transfer by consenting to and actively participating in the sale. Jackson
23 v. Taylor, 272 Cal. App. 2d at 6; Shepherd v. Robinson, 128 Cal. App. 3d at 625.

24 Here, the issue is whether the sale of the Property from the Four-Plex Group to Tomanek in
25 1983, which is a variation from the standard transaction, should be transmuted into a purchase money
26 transaction to which § 580b should be applied. The court concludes that the Tomanek Notes should
27 be treated as purchase money notes because Carter, on behalf of Carter/Miller, both actively
28 participated in and was necessary to the sale of the Property to Tomanek. Jackson v. Taylor, 272

1 Cal. App. 2d at 6; Shepherd v. Robinson, 128 Cal. App. 3d at 625. Carter negotiated the terms of
2 the secondary financing on the sale to Tomanek, establishing the interest rate and the term of the
3 Tomanek Notes. Carter's approval of the purchase price was also necessary.

4 The court also concludes that Carter's participation in the negotiations and in the bankruptcy
5 case of the Four-Plex Group was necessary to the terms of the transaction and to the consummation
6 of the sale to Tomanek. His attempts to foreclose before and during the pendency of the bankruptcy
7 motivated the Four-Plex Group to consummate a sale. Carter also compromised the amount of his
8 secured claim against the bankruptcy estate, facilitating the sale which closed pursuant to the terms
9 negotiated. His efforts were directed at preserving his equity interest in the Property. Carter
10 ultimately received \$750,000 from the close of escrow on the sale to Tomanek and received the
11 benefit from that transaction. Under the facts, it is appropriate to construe Carter as a "vendor" in
12 the sale from the Four-Plex Group to Tomanek. In view of the court's earlier finding that the
13 Tomanek Notes should be characterized as purchase money notes, Jackson v. Taylor and its progeny
14 merely provide an alternative basis by which the court may conclude that the Tomanek Notes are
15 subject to § 580b.

16 The question also arises whether the sale from Tomanek to the Khans should be transmuted
17 into a purchase money transaction. The evidence indicates that, although Costanzo's agreement to
18 accept the Khan Notes provided the financing necessary to consummate the sale, neither she nor her
19 agent actively participated in the sale to the Khans. Although the evidence does not support
20 transmuting Costanzo into a "vendor" in the sale to the Khans under Jackson v. Taylor, the character
21 of the Khan Notes and the policies of § 580b would be served by barring Costanzo from a deficiency
22 judgment.

23 24 2. Policy Objectives of § 580b

25 For the anti-deficiency statute to be applied to a non-standard transaction such as the sale
26 from the Four-Plex Group to Tomanek, not only must the lender have actively participated in and be
27 necessary to the transaction, but the policy objectives of § 580b must also be served. California
28 historically has had a strong public policy against deficiency judgments. The policy objectives of the

1 anti-deficiency legislation are two-fold: to prevent overvaluation by the seller and to stabilize
2 property values.

3 The overvaluation mechanism is intended to prevent an unrealistically high initial sales price
4 such that a deficiency judgment will almost surely follow a foreclosure sale because the value of the
5 property is less than the amount of the debt. This first objective places the risk of inadequate security
6 on the vendor or lender, who is in the best position to know its true value and to discourage a seller
7 or lender from overvaluing the collateral above its fair market value. Roseleaf v. Chierighino, 59 Cal.
8 2d 35, 42, 27 Cal. Rptr. 873 (1963). The Roseleaf Court articulated the policy objectives as follows:

9 Section 580b places the risk of inadequate security on the purchase
10 money mortgagee. A vendor is thus discouraged from overvaluing the
11 security. Precarious land promotion schemes are discouraged, for the
12 security value of the land gives purchasers a clue as to its true market
13 value. (Citations omitted). If inadequacy of the security results, not
14 from overvaluing, but from a decline in property values during a
general or local depression, section 580b prevents the aggravation of
the downturn that would result if defaulting purchasers were burdened
with large personal liability. Section 580b thus serves as a stabilizing
factor in land sales.

15 Id. By enacting the anti-deficiency legislation, the California legislature sought to prevent a secured
16 creditor from setting an artificially high purchase price, foreclosing, purchasing the property at a
17 foreclosure sale for less than its fair market value, and then recovering a personal judgment from the
18 borrower for the difference between the sales proceeds and the balance of the unpaid debt.

19 There is evidence that the Alvarado-Niles Property was over appraised in 1983 when World
20 Savings extended financing to Tomanek to facilitate the purchase of the Property. The result of the
21 excessive appraisal was that the Property became overencumbered and was effectively overvalued
22 for purposes of application of § 580b. The income from the Property was clearly insufficient to
23 support the debt from the time of the sale to the Four-Plex Group and thereafter. Carter was aware
24 of the overvaluation based on his experience with the Property. Tomanek should have been aware
25 of the overvaluation because the Property was overfinanced when he purchased it in 1983 and he
26 received funds from the escrow. Although Carter did not advise Costanzo of the overvaluation, she
27 should have been aware of the problem by the time she accepted the Khans Notes in 1984. Her 1988
28 deposition testimony indicates that her former husband informed her that the Property was

1 overencumbered after the sale to Tomanek. The relative astuteness of the buyer and the seller is not
2 determinative of whether the anti-deficiency statute should be applied, so it is not relevant to the
3 court's determination of the applicability of § 580b whether Costanzo was sophisticated. Roseleaf,
4 27 Cal. Rptr. at 877. The overvaluation ultimately precipitated the Khans' default and foreclosure.
5 The court concludes that the objective to prevent overvaluation is served by application of § 580b
6 to Costanzo.

7 The stabilization mechanism inherent in the statute is intended to apply to situations in which
8 the parties initially set a proper selling price, but the market subsequently declines, and the security
9 can no longer support the debt. Id. at § 4.28. The stabilization policy is not directed at the immediate
10 parties to the transaction but is aimed at slowing down an overall economic depression. Id. The
11 assumption appears to be that a trustor who loses the security is more likely to default on his or her
12 other obligations if also faced with a deficiency judgment. Id. In turn, unpaid creditors may face
13 financial difficulties, aggravating a downturn in the economy.

14 The court notes the general depression in property values between the Khans' purchase in
15 1984 and the foreclosure in 1987. There is also evidence of failure to attend to deferred maintenance
16 on the Property. Nevertheless, this factor is not of particular significance to the court's conclusion
17 that § 580b is applicable.

18 For these reasons, the statute is appropriately applied to protect the Khans from a deficiency
19 balance on the notes to Costanzo. The remainder of the discussion is directed toward explaining why
20 the theories propounded by counsel for Costanzo are inapposite.

21 22 C. Kistler Is Factually Distinguishable

23 The case of Kistler v. Vasi, 455 P.2d 106, 78 Cal. Rptr. 170 (1969), relied upon by counsel
24 for Costanzo, addresses an area in which case law has construed § 580b strictly. In that case, Kistler,
25 as a real estate broker, accepted a note secured by a second deed of trust in lieu of his commission
26 on a real property exchange. When the holder of the first deed of trust foreclosed, Kistler's note
27 became unsecured and Kistler sued to recover the balance due. The California Supreme Court held
28 that Kistler was a third-party purchase money lender not precluded from a deficiency judgment under

1 § 580b. Id. at 171. The Court read the text of the statute narrowly, indicating that the legislature
2 simply did not contemplate that third-party lenders would be within the ambit of the statute. Id. The
3 Court suggested that a purchaser of commercial property that wished to avoid a deficiency judgment
4 could negotiate to structure the financing accordingly. Id. at 171-72.

5 Kistler is distinguishable from the transaction between the Khans and Costanzo because,
6 contrary to Costanzo's assertions, she is not a third-party purchase money lender. Costanzo is,
7 instead, a former owner of the property. As a former owner, Costanzo had several opportunities to
8 retire the Carter Note. Specifically, Costanzo failed to exercise her rights under the due-on-sale
9 clause in the sale to the Four-Plex Group, and she accepted notes in lieu of payment when the
10 Property was sold to Tomanek, and again, when the Property was sold to the Khans.

11 The only explanation presented concerning Costanzo's motive for accepting the notes rather
12 than payment in full was the testimony of her former accountant. Hawn, referring to worksheets that
13 he had prepared for Costanzo detailing the tax ramifications of the transactions, testified that he
14 advised her of the adverse tax consequences of accepting full payment. Costanzo's motivation
15 resulting from tax incentives differentiates her from the real estate broker in Kistler, who was
16 arguably persuaded to extend credit because he believed that the value of the property would support
17 his taking a junior deed of trust. The evidence establishes that tax incentives rather than the value of
18 the sales transactions as investments influenced Costanzo to continue to carry the financing on the
19 Property. Although not argued by counsel, it is inappropriate to permit Costanzo to be treated as a
20 vendor for purposes of the Internal Revenue Code and the California Revenue and Taxation Code,
21 yet to treat her as a third-party lender for purposes of the application of § 580b.

22 It is the charge of this court to look beyond the form to the substance of the transaction in
23 applying § 580b. Scott v. Fidelity Development Co., 39 Cal. App. 3d at 135, 113 Cal. Rptr. at 858.
24 In so doing, the court concludes that § 580b should be applied to this case. The remaining
25 arguments raised by Costanzo's counsel must fail because they are not supported by the facts.

26 27 CONCLUSION

28 Under the facts in this case, Costanzo's claim is barred by the application of § 580b.